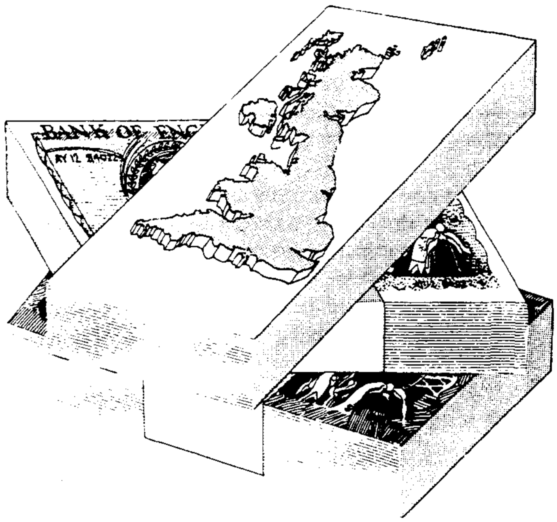
Love, Jim and Ashcroft, Brian and Brooks, Richard and Draper, Paul and Dunlop, Stewart and Leif, Kevin and Lockyer, Cliff and Malloy, Eleanor and McFarland, Mark and McGregor, Peter and McNicoll, Iain and McRory, Eric and Perman, Roger and Stevens, Jim and Swales, Kim and Yin, Ya Ping (1992) The British economy [June 1992]. Quarterly Economic Commentary, 17 (4). pp. 6-10. ISSN 0306-7866 ,

THE BRITISH ECONOMY



OVERVIEW

The recession in non-oil GDP has continued for seven quarters since the last peak in the second quarter of 1990 with output falling by over 4%. There are some signs that domestic demand is beginning to pick up but the recovery is likely to be slow with only weak growth during the remainder of 1992.

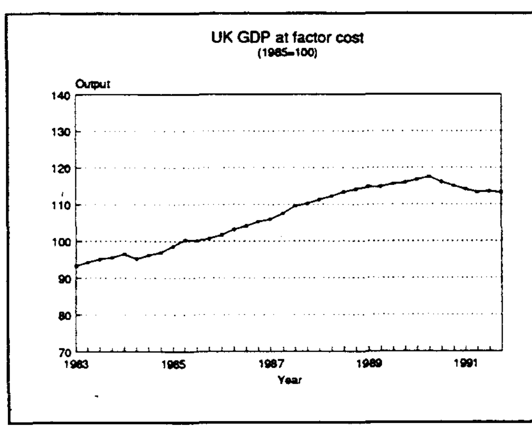
MACROECONOMIC TRENDS

In the fourth quarter of 1991, the average measure of **GDP at market prices - 'money' GDP** - rose by 0.9%. After allowing for inflation and adjusting for factor costs, **GDP** fell by 0.3% during the quarter, compared with a slight increase of 0.2% in the third quarter and reductions of 0.9%, 0.8%, 0.9%, and 1.1% respectively in the preceding four quarters. Over the year to the fourth quarter, 'real' GDP is estimated to have fallen by 2.4%, and by 3.6% since the recession began in the second quarter 1990.

Preliminary estimates of the **output based measure of GDP** - which is usually taken to be the most reliable indicator of short-term change - in the first quarter of 1992, suggest that activity fell by 0.6% compared with the previous quarter. When oil and gas extraction are excluded, GDP is estimated to have fallen by 0.4% in the most recent quarter, reflecting a large fall in energy sector output. Output of the service sector is estimated to have fallen but, more encouragingly, manufacturing output is estimated to have risen by 0.3%, and the transport and communications sector also appeared to be relatively buoyant.

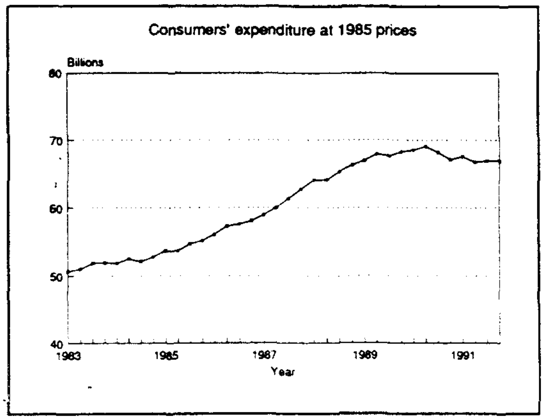
The **output of the production industries** in the first quarter of 1992 is provisionally estimated to have fallen by 1% over the preceding quarter to a level 1.5% below that produced in the same period a year ago. As noted, manufacturing experienced an increase in output of 0.3% in the first quarter, while production in the energy sector decreased by 4.3%. Within manufacturing, Other manufacturing output rose by 1.4%, Metals output rose by 1.1%, Food, drink & tobacco output rose by 1%, and output in the Chemicals sector rose by 0.1%. Output in the remaining key sectors fell: in Textiles by 0.1%, in Other minerals by 0.3%, and in Engineering by 0.3%. Generally, manufacturing performed much better in the first three months of this year than in the fourth quarter of 1991. Output in the investment and intermediate goods industries fell between the latest two quarters by 1.4% and 1.8% respectively, while production of consumer goods rose by 1.3%.

Despite the continuing fall in GDP into the first quarter of the year there are some positive signs from the first quarter figures. The fall in manufacturing output, which we noted with concern in the previous **Commentary**, has now reversed. The sector had been in decline since the second quarter of 1990 and by the fourth quarter of 1991 output had fallen by just under 8%. With this increase manufacturing output now stands 7.7% below the last peak. Equally encouraging is the rise in the output of the consumer goods sector which had also been in continuous decline since the second quarter 1990. It is to be hoped this presages an increase in stockbuilding in anticipation of a sustained rise in consumer demand.



The CSO's **co-incident cyclical indicator** for March 1991, which attempts to show current turning points around the long-term trend, rose slightly, although the index for the month was based on partial information and so should be viewed with caution. The index appears to have flattened out since November last year and may be poised for an upturn which will only be confirmed when more complete information becomes available. The **shorter leading index**, which attempts to indicate turning points about six months in advance, rose sharply in February and March but again a lack of full information on the component series suggests caution. The **longer leading index**, which purports to indicate turning points about one year in advance, had been rising strongly since January 1991, but began to fall back again in November and December of last year and this fall continued into January and February. However, the relatively favourable responses to the CBI April survey questions on new orders and expected changes in stocks of raw materials resulted in the Index rising again in April, although at that time information on two of its component series was not available.

In the fourth quarter of 1991, **real consumers' expenditure** remained largely unchanged 0.1% after falling slightly by 0.1% in the third quarter, 1.6% in the second quarter, and 0.2% in the first quarter. Spending during the fourth quarter therefore stood 1.3% below the same period a year earlier and for 1991 spending was 1.7% lower than in 1990. In the fourth quarter, spending on durables fell by 2.3% after the surge in motor vehicle demand in the third quarter.



The provisional official **retail sales** figures - seasonally adjusted - for April, rose by 0.8% after falling by 1% in March. The increase over the year to April therefore stood at 1.2%. Taking the three months to April, the volume of retail sales fell by 0.3% to a level 0.5% down on the same period a year ago. The **CBI Distributive Trades Survey** for April also indicated a rise in sales volumes in distribution for that month. Orders remained up on April 1991 in both retailing and wholesaling with retailers recording their highest sales for two years. Overall, then, the recent data on consumers' spending, retail sales and the performance of the distributive trades, provide some indications that spending is rising but there would appear to be some way to go before there is a full recovery in the fortunes of the high street.

The underlying determinants of consumers' spending are nevertheless still weak. The **consumer credit** figures for March show that the cumulative amount of outstanding credit (excluding bank loans) fell by £69m. The amount of outstanding credit has been falling since August except for a small net increase of £13m in February. In the first quarter of 1992, the balance of outstanding credit fell by £118m suggesting that consumers are still putting a lot of emphasis on reducing the debt overhang and spending is weak as a result. On the other hand, bank and building society lending was relatively buoyant in April suggesting that confidence among businesses and consumers may be improving.

The **saving ratio** fell slightly in the third quarter 1991 to 10.9% from 11.2% in the second quarter of 1991 after rising from 9.2% in the first quarter. The savings ratio averaged 8.9% in 1990, compared to 7.1% in 1989 and 5.4% in 1988. **Real personal disposable income** fell slightly by 0.2% in the third quarter of last year, after rising by 0.6% in the second quarter and falling by 1.6% in the first quarter. RPDI was 0.6% lower in the third quarter 1991 than in the same period in 1990.

The underlying increase in **average weekly earnings** in the year to March is provisionally estimated to have been 7½%. This compares with a 7½% increase in the year to February and a 7¼% increase in the years to December and January. Despite the recent increase in the rate from 7¼% to 7½% the underlying increase has been slowly moderating after the peak increase of 10¼% in the year to July 1990. The current rate of increase still remains above the rate of consumer price inflation.

General government final consumption rose very slightly by 0.1% in the fourth quarter of 1991 to a level 1.9% higher than in the fourth quarter 1990. Spending rose by 0.4% in the third quarter, remained largely unchanged in the second quarter and rose by 1% in the first quarter.

Real gross fixed investment continues to decline. In the fourth quarter gross domestic fixed capital formation fell by 1.8% to a level 8.5% below the same period a year earlier. Investment in vehicles, ships and aircraft rose by 21.1% after the 21.9% fall in the third quarter, while investment in plant and machinery fell by 0.9%, investment in dwellings fell by 5.5% and in other new buildings and works it fell by 5.3%. Over the year to the fourth quarter vehicles etc investment fell by 13.6%, plant and machinery fell by 4.9%, dwellings fell by 1.8%, and other new buildings etc fell by 13.8%. Overall, GDCF has fallen by 15.6% since its last peak in the first quarter of 1990.

Stockbuilding by manufacturers, wholesalers, retailers and other industries in the fourth quarter 1991 is estimated to have decreased by £467m (1985 prices, seasonally adjusted), compared with a fall of £644m in the third quarter. The ratio of manufacturers stocks to output (Q4 1984 = 100) fell from 79.4 at the end of September to 78.8 at the end of December 1991. So by the end of last year there was clearly no evidence of manufacturers building up their stock holdings in anticipation of an expansion in demand in the new year.

Turning to the **balance of payments**, the deficit on **current account** for the fourth quarter 1991 was, after seasonal adjustment, £0.6bn compared with £1.2bn in the third quarter, with £0.2bn in the second quarter and £2.3bn in the first quarter. For 1991 the current account deficit of £4.4bn compared with £15.4bn in 1990 and £20.4bn in 1989. On **visible trade**, the fourth quarter deficit rose to £2.6bn from £2.3bn in the third quarter, £2.2bn in the second quarter and £3bn in the first quarter. Within this account, the surplus on **oil** rose to £481m, from £315m in the third quarter, £209m in the second quarter and £213m in the first quarter. The surplus on **invisibles** rose to £1.9bn from £1.1bn in the third quarter, £2.0bn in the second quarter and £0.7bn in the first quarter.

THE LABOUR MARKET

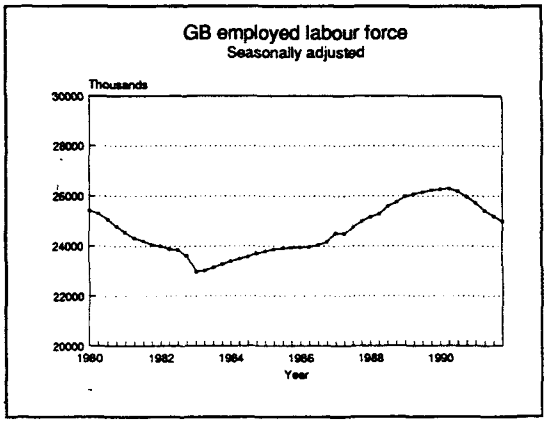
Employment and unemployment

The figure for UK workforce in employment has now fallen for six quarters in succession and in December 1991 stood at a total of 25,597,000. The reduction in the last quarter was 226,000 (0.9%), 123,000 of whom were female. This is the first quarter since the beginning of the recession that the decline in female employment has been greater than the decline in male employment. The reduction in total employment over the last year was 997,000 (3.7%) and there is as yet no real indication that this decline is levelling off. Sectoral disaggregation indicates that again for the first time in this recession, employment fell by more in the service sector (97,000) than in manufacturing (60,000), although because of the larger initial scale of services the proportionate decline in this sector over the quarter (0.6%) is less than one half of the proportionate decline in manufacturing (1.3%). More up to date figures are available for British manufacturing employment and these indicate a continuing decline to March 1992, where the employment fall over the quarter was 72,000 (1.6%), a reduction greater than that in the previous two quarters.

The provisional estimate for UK seasonally adjusted claimant unemployment in April 1992 was 2,695,300, an overall unemployment rate of 9.5%, with the separate male and female rates standing at 12.8% and 5.2% respectively. UK unemployment has now been rising continuously for over two years, with the increase in the last quarter of 88,200 and in the last year of 528,700. Although the rate at which unemployment is rising is lower than a year ago, the month on month changes in unemployment are very variable, showing no consistent downward trend. Accompanying a continuous increase in unemployment has been a relatively constant level of job vacancies. In the quarter to April 1992, the seasonally adjusted level of unfilled vacancies in Jobcentres fell by 2,400 (1.9%) to 119,600, a total which is (1.8%) lower than the figure for April 1991.

Earnings and productivity

The provisional actual seasonally adjusted annual increase in British whole economy average earnings up to March 1992 was 8.5%, though the underlying increase was lower at 7.5%. The difference between the actual and underlying rates is explained by timing adjustments for bonuses paid in different months in 1991 and for some workers having received two pay increases. The level of underlying wage inflation had been falling slowly, but consistently, for 18 months to January 1992, when it stood at 7.25%, but the underlying rate has started to increase in the last two months. For each month since March 1991, the level of underlying wage inflation in services has been lower than in production or manufacturing industries. In March 1992, the underlying wage inflation in services stands at 7% as against 8.25% in these other sectors.



After a period of negative whole economy annual productivity changes, the figures for the third and fourth quarter of 1991 are positive and increasing at 1.1% and 1.8% respectively. Annual manufacturing productivity changes also became positive in the third quarter of 1991 and the figures for the fourth quarter and the quarter up to February 1992 are 2.6% and 2.9%. These results, combined with the wage inflation figures mean that the unit labour costs in the whole economy continued to rise at the substantial annual rate of 5.7% to the fourth quarter of 1991, though there has been a sharp and monotonic reduction from the figure of 10.5% for the third quarter of 1990. Moreover, the annual increase of unit labour costs in manufacturing has shown an even sharper decline in the recent past, from 10.9% in the fourth quarter of 1990 to 4.9% in the corresponding quarter of 1991, and this decline continues in the months to February 1992 when the annual rate for manufacturing stood at 3.4%.

PROGNOSIS

The recession in non-oil GDP has continued for seven quarters since the last peak in the second quarter of 1990 with output falling by over 4%. As pointed out in the March Commentary, the key to the fortunes of the British economy during the current year is the behaviour of the consumer. Consumers' expenditure accounts for 66% of GDP and is therefore the principal component of aggregate expenditure or demand.

There are some signs that spending is beginning to pick up, for example, new car sales rose by 9.1% in April, the first year-on-year increase in 30 months. (The rise was somewhat artificial though since demand a year ago was depressed by the higher rate of VAT introduced in the 1991 Budget). However, despite the 0.8% increase in retail sales in April they are not strong and consumers continue to cut back on debt. Coupled with the large debt overhang, unemployment continues to rise, both of which work to moderate the rate of growth of consumer demand. On top of this asset prices continue to be weak with the housing market reporting the lowest turnover since 1977 and prices either static or falling, although there appears to have been a post-election increase in sales assisted in part by the earlier mortgage rate cut and the decision in the Budget to suspend stamp duty on house purchases. This weakness in the domestic economy was clearly the major factor in the government's recent decision to cut a further 0.5% off base rates to 10%.

Despite the present hesitant evidence of recovery in spending it appears that consumer confidence has risen after the election and that modest spending growth will occur for the remainder of the year. We therefore expect that there will be further falls in the savings ratio during the year and increased spending encouraged by:

- the fall in base rates;
- some upward movement in house prices;
- a move closer to more adequate levels of debt following recent net repayments; and
- a further slowdown in the rate of increase of unemployment.

Consumption should therefore rise by about 1% this year with a similar increase in GDP. In sum the recession will end in 1992 but we must wait to 1993 before growth of any significance materialises.

Medium term outlook to 1994

Turning to the medium term, we can expect GDP growth to average around 2.6% in 1993 and 1994 as consumption growth recovers, destocking ends and investment recovers appreciably. GDP growth should be lower on average than in the late 1980s reflecting less buoyant domestic demand and a slower growth in world trade.

Inflation should fall to 3% in 1993 over 1992 helped by continuing spare capacity, average earnings growth falling to around 5 to 6% in 1993, and limited increases in unit labour costs due to the productivity gains secured following the shake out in the recession. However, some of these effects will be transitory and inflation should be expected to settle at around 4% pa in 1994 over 1993.

Unemployment responds with a lag of nine months or more to changes in demand so we should not expect much evidence of improvement until 1993. Unemployment should approach 2.9m by the end of 1992 and decline very slowly thereafter.

What of the prospects of sustained growth in medium to long term?

This depends on several key issues:

a) External influences

Given that exports account for 31% of UK GDP, strong growth in world trade is a major requisite for sustained GDP growth in the UK. The prospects for the three major economies are uncertain. However, while the US does appear to be coming out of recession there is greater uncertainty about Japan and Germany (see World Economy section).

b) Sterling in the ERM

A consideration of the UK's current account should give serious cause for concern. Even in 1991 with UK output falling by the largest amount since 1931 we still ran a significant deficit of £4.4bn. Ordinarily in recessions falling demand reduces imports significantly and the desire to protect production and profits leads producers to make greater efforts to sell into export markets. The results is usually a surplus or a small deficit on current account. Conversely, when demand expands import growth often outstrips export growth and the deficit worsens. The key question then is whether as the UK moves out of recession the deficit will worsen and to what extent, for a worsening deficit will almost certainly force the government to restrict domestic demand thus choking off the renewed growth. However, presently the situation is much worse than previously for not only did the UK have a significant deficit in the recession but the usual means of mitigating the effects of a balance of payments constraint - a depreciation of the exchange rate - is now not open to us due to our membership of the ERM. Many economists argue that a 2.95 central rate of the £ to the DM is too high and that the UK's FEER (Fundamental Equilibrium Exchange Rate) is appreciably lower. In other words the UK entered the ERM at a too high rate and this will condemn us to permanently slower growth and higher unemployment than otherwise would have been the case.

Other economists argue however that the present parity will provide a discipline which will lead to significant productivity improvements in the tradeable sector - mainly manufacturing - leading to a slower growth of unit labour costs, lower relative inflation, increased competitiveness and higher real incomes. In this view, due to ERM membership at the current rate, productivity improvements will overcome the balance of payments constraint allowing the economy to move to a 'virtuous' growth cycle.

There is no way of telling at the moment which view is correct except to say that the supply side improvements of labour market and trade union reform, tax reform, privatisation, and deregulation, which were the fruits of Thatcherism in the 1980s were not enough to stop the rapid growth in demand in 1986 and 1987 from quickly running into imports and a current account deficit.

c) The PSBR

The PSBR, which is the difference between what the government spends and receives in tax receipts, is expected to rise to around £20bn in 1992 and £30bn in 1993, around 2.5% and 4% respectively of GDP. A high PSBR is usual in a recession and should pose no problem provided that over the cycle there is rough balance or a much smaller PSBR or budget deficit. However, a key issue will be whether the government can resist the demands for further growth in public expenditure.

d) Productivity growth and sectoral restructuring

The movement towards European integration via the single market, the ERM and eventually EMU will impose severe pressures on the UK economy to raise productivity and competitiveness right across the British economy. Presently there is still a continuing productivity gap between British firms and their competitors in Europe. The gap has narrowed substantially over the last ten years but at the cost of a significant fall in manufacturing employment. These pressures are beginning now to extend to the service sector - particularly traded services. We are therefore likely to see significant restructuring in key sectors such as Banking and Financial services through takeovers and the introduction of labour saving investment. Unemployment levels are therefore likely to remain high for much of the 1990s. Moreover, if we are to narrow the productivity gap further between the UK and Germany and France we must raise appreciably the general level of skills training, the level of capital investment and the adoption and generation of new technologies and product and process innovations. This is undoubtedly the greatest challenge facing policymakers and the British economy as we approach the new millennium.